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C O N F I D E N T I A L SECTION 01 OF 04 CARACAS 000207

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USDOC FOR 4332 MAC/ITA/WH/JLAO
AMEMBASSY BRIDGETOWN PASS TO AMEMBASSY GRENADA
AMEMBASSY OTTAWA PASS TO AMCONSUL QUEBEC
AMEMBASSY BRASILIA PASS TO AMCONSUL RECIFE

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TAGS: ECON EFIN VE
SUBJECT: Venezuela's Financial Sector: Fragility Grows, but Neither Complete Nationalization nor Systemic Crisis Likely

REF: 08 CARACAS 566; 09 CARACAS 1509

CLASSIFIED BY: DUDDY, AMBASSADOR, DOS, AMB; REASON: 1.4(B), (D)

¶1. (C) Summary: Venezuela's financial sector is showing increasing fragility. The Venezuelan government (GBRV) now controls 28 percent of the banking sector's assets (up from 12 percent one year ago), has established a foothold in the insurance sector, and has taken at least temporary control of a number of brokerages. The episode of interventions that began in November 2009 in the banking sector has spread into the brokerage sector and does not appear to be over. Buffeted by the recession, increased government scrutiny, new regulations, and greater difficulties in doing business with U.S. financial institutions, smaller and less well established banks and brokerages are struggling and in some cases going under. This situation is causing the sector as a whole to shrink in real terms and has caused some shifts in market share. Private sector banks may struggle with profitability this year (with the exception of exchange rate gains from the devaluation), nevertheless, a systemic crisis appears unlikely in the near future, as does complete nationalization of the sector. End summary.

The Recession Hits the Financial Sector

¶2. (SBU) The bursting of Venezuela's economic bubble in late 2008 brought profound changes to the financial sector. Thanks to currency controls, massive increases in liquidity, and high growth rates, the banking sector, despite heavy regulations, grew at a stunning rate in almost every indicator from 2004 through 2007 (ref A). Brokerages blossomed in numbers and in assets under management, attracted by a relatively lax regulatory environment and new business opportunities in the parallel foreign exchange market. As economic growth slowed dramatically in late 2008, however, banks cut back their lending in real terms and profitability dropped. The financial sector was hard hit by the recession of 2009 in which Venezuela's economy contracted 2.9 percent. The size of the financial sector relative to the economy decreased, the sector's assets diminished in real terms, and banks shifted a significant percentage of their asset portfolio from loans to government bonds as credit opportunities dried up and the GBRV issued large amounts of internal debt.

Bank Interventions and Their Aftermath

¶3. (SBU) In addition to causing the general trends mentioned above, the bursting of Venezuela's economic bubble brought to light bad, illegal, and/or unethical practices in the financial sector. These practices appear to have been concentrated in banks and brokerages acquired or in the process of being acquired by new entrants to the sector generally with close ties to the GBRV. Whether because of infighting within Chavismo or because the banks in question had become so bad that action had to be taken, the GBRV took over 4 banks in November 2009 (ref B), beginning a series of interventions that had encompassed 11 banks and a smaller number of brokerages by mid-February 2010.

¶4. (SBU) Associated with these interventions are a number of important corollaries. The GBRV decided to absorb four of the intervened banks into a new public bank, Banco Bicentenario. With the creation of Bicentenario and the purchase of Banco de Venezuela, one of the country's largest private banks, in July 2009, the GBRV now directly controls roughly 28 percent of the banking sector as measured by assets, up from 12 percent in January ¶2009. The GBRV also turned an insurance company belonging to one

of the intervened banks into state-owned Bolivariana de Seguros, its first foray into the insurance sector. Finally, the GBRV changed the laws regulating banks and brokerages in important ways. Regarding banks, the GBRV increased the deposit guarantee and then increased private banks' mandatory contribution to FOGADE, the guarantor, from 0.5 to 1.5 percent of deposits annually. (Note: Initially, in what a banking executive called "a Negotiations 101 move," the GBRV raised it to 3 percent, a level which would have made it virtually impossible to turn a profit. In response to lobbying by banks, the GBRV reduced the increase but gave public sector banks an advantage at the same time, fixing their contribution at 1 percent. End note.)

Brokerages Feeling the Regulatory Heat Too

¶5. (SBU) The government also moved to eliminate a key financing tool used by brokerages and to force them to reduce their leverage. Brokers associated with some of the intervened banks used this tool, known as a "mutuo," to structure the financial deals by which the banks were bought with depositors' money and then financed companies affiliated with the new owners. (Note: Mutuos are essentially an instrument by which brokers practiced intermediation, i.e. receiving deposits and making loans. When used responsibly, mutuos allowed brokers to fill a useful financial niche. They were sometimes used irresponsibly, however, for example to structure deals such as those mentioned above, to make risky bets on the exchange rate, and even allegedly to acquire assets such as airplanes for brokers' personal use. End note.) On February 1, the GBRV issued a decree requiring brokers to unwind their mutuos in 90 days and to reduce progressively their debt to equity ratio to 2:1 over 6 months. The GBRV is also apparently considering a general policy of not allowing brokerages to participate in primary GBRV bond issuances; it excluded brokers, though not banks, from a recent issuance of short-term domestic debt.

Squeeze from the Outside

¶6. (C) Venezuela's contracting economy and new government regulations are not the only factors squeezing the financial sector. Over the past six to eight months, we have observed a trend by which Venezuelan banks and brokerages, particularly less well established ones, are finding it increasingly difficult to do business with counterparts in the United States and elsewhere. It is impossible to quantify this trend, but we can offer anecdotes. Representatives of three major multinational or U.S. banks have recently told us they are reviewing closely accounts they have open with Venezuelan banks and brokers, with several of them expressing particular concern about accounts used for parallel market operations. In one case, the U.S. bank in question, Wells Fargo, closed a longstanding account Wachovia (acquired by Wells Fargo) had with Intertrust, a local broker, according to Intertrust directors (strictly protect throughout). We know of at least two other cases where U.S. accounts of local brokers have been closed. These closures, which spring from compliance-related concerns at U.S. banks, appear mostly to affect smaller, less well-established financial institutions. Philip Henriquez (strictly protect throughout), an executive at Banco Mercantil (one of Venzuela's largest and most respected banks), said Mercantil did not anticipate problems with its major correspondent banks but noted that a Canadian bank had recently closed a little-used account Mercantil had with it. Citibank Venezuela president Bernardo Chacin (strictly protect throughout) noted that Citibank recently closed several correspondent bank relationships it had with less well established Venezuelan banks while keeping those with highly respected banks such as Mercantil and Venezolano de Credito.

Outlook for 2010

¶7. (C) A key question for the financial sector in 2010 is how much farther the interventions will spread. In separate recent meetings, executives at three brokerages and two banks said they expected more interventions of brokers. Directors at Intertrust said they were confident in the health of only 8 to 10 brokerages and could not speak to the others. (Note: There are approximately 100 registered brokers in Venezuela, including both "casas de bolsa" and the generally smaller "sociedades de corretaje." End note.) Henriquez claimed that only brokers associated with the first wave of bank interventions had been touched to date, noting he expected brokers associated with the rest of the intervened banks to be intervened themselves. Chacin and Milton Guzman (strictly protect throughout), chief economist for Valores Santander, said they expected some brokers would be unable to unwind their mutuos and deleverage within the required time frame given asset-liability mismatches and, in some cases, poor asset quality. Whether there will be more bank interventions is unclear. We are not aware of any remaining banks that fit the exact profile of the intervened banks, but there are others whose financial health is questionable. Chief among these is Banco Federal, owned by Nelson Mezerhane, who is also a minority shareholder in opposition TV station Globovision. Mezerhane (protect) told the Ambassador on February 18 that his bank had been under pressure to force him to help engineer a change in Globovision's management and editorial line. (There will be septel reporting on this subject.) According to Chacin, many Venezuelan bankers feel GBRV takeover of Banco Federal, should it occur, would greatly widen the potential scope of the interventions and could lead to severe problems at a number of other banks, though not the largest and most solvent ones.

¶8. (C) Despite the probability of further interventions in brokerages and perhaps in banks, our financial sector contacts do not foresee a systemic crisis (except if the GBRV should intervene in Banco Federal, as discussed above) or wholesale nationalization of the sector in 2010. Most major private sector banks, still the lynchpin of the sector, remain in good shape. While President Chavez's comment the week after the first bank interventions about being "willing to nationalize the entire sector" raised the specter of wholesale government takeover, Chavez quickly backtracked.

Contacts such as Henriquez and Guzman believe the GBRV understands it does not currently have the capacity to manage the entire sector and would not at this point want to introduce the kind of disruption wholesale nationalization would entail. Instead, our contacts expect a continued "flight to quality," as private clients of state-owned and weaker private banks seek to move their business to more conservative and respected private banks, a trend somewhat balanced out by movement of public sector deposits to newly public Banco de Venezuela. The size of the sector seems almost certain to contract in real terms, reflecting Venezuela's general economic situation and the diminishing importance of traditional financial intermediation in the GBRV's economic model. Profits will also likely decline in real terms, excluding one-time gains from the devaluation.

Comment

¶9. (C) It is interesting to speculate why the GBRV has chosen to carry the intervention episode as far as it has, particularly with regard to the new requirements for brokers. There is clearly a technical component, with regulators justifiably going after banks

and brokers that abused the system. The decision to force brokers to unwind mutuos and deleverage could be justified on technical grounds as well, though it is hard to understand why the GBRV is considering excluding brokers from participating in bond issuances. Our contacts in the brokerage industry feel other factors may be at work, however. The GBRV may want to rein in brokers as part of its quest to control the financial sector, indirectly if not directly. More specifically, as Intertrust's directors pointed out, brokers are the key players in the parallel foreign exchange market, and the GBRV's actions may be aimed at trying to lower pressure in the exchange market which pushes the bolivar lower against the dollar by reducing the brokers' scope of action. End comment.
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